No. 16702.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

SCHALK CHEMICAL COMPANY, a corporation, GERALD I. FARMAN, HAZEL I. FARMAN, JOHN CARVER BAKER and PATRICIA BAKER,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Review of Decisions of the Tax Court of the United States.

PETITION FOR REHEARING.

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TABLE OF AUTHORITIES CITED

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To the Honorable Albert Lee Stephens, Stanley N. Barnes and M. Oliver Koelsch, United States Circuit Judges, before whom this case was heard:

Petitioners respectfully petition for a rehearing in this case on the following grounds:

I.

The Court holds that if Farman, Baker and Marlow had breached the settlement agreement they would have been liable in damages to Smith and, since this possible liability was discharged by the $20,000 payment which Schalk made to Smith, the payment constituted a constructive dividend proportionately to Farman and Baker (Op. pp. 8-9).[1] The Court apparently agrees that if no obligation existed which Schalk discharged by the

[1]The references are to the printed slip opinion.

$20,000 payment to Smith, no constructive dividend resulted. *Holsey v. Commissioner of Internal Revenue,* 258 F. 2d 865 (3 Cir. 1958), is distinguished on this ground (Op. p. 5 f.6).

The Court does not mention and presumably gave no consideration to the following provision of the settlement agreement:

> "In the event that Second Parties, their heirs, successors, or assigns, shall fail, neglect or refuse to pay the balance [$20,000] of the purchase price as herein provided, First Party [Smith] shall be released from any and all obligation to sell, transfer, convey or assign the property herein described, and Second Parties [Farman, Baker and Marlow], their heirs, successors and assigns, *shall be released of any and all obligations to purchase said property or to pay to First Party any additional moneys hereunder.*" [Ex. 16, p. 5. Emphasis added].

Schalk's $20,000 payment to Smith satisfied no possible liability of the other shareholders to Smith, and, as in *Holsey,* the payment resulted in no constructive dividend as to them.

The mutual release provision also supports petitioners' argued position that the $25,000 payment was for Smith's resignation as supervisor of the trust and the $20,000 payment was for his stock interest. If the latter payment were not made and the mutual release became operative, Smith was to retain the $25,000 payment *and* his stock. If the $25,000 was part payment on the stock, he could not retain both without being unjustly enriched to the extent of the value of the stock. *Cf., e.g., Freedman v. The Rector,* 37 Cal. 2d 16 (1951). The illegality is avoided if the $25,000 is treated, as it should be, as payment for his resignation, not his stock.

In this regard, petitioners do not contend that the settlement agreement is "divisible" into two separate

contracts (*cf.* Op. pp. 3-4, 6-7). They do contend that the $25,000 was for Smith's resignation as supervisor of the trust and the $20,000 was for his stock interest.

The mutual release provision has an important bearing on the issues respecting the $20,000 payment (constructive dividend) and respecting the $25,000 payment (deductibility and dividend equivalence). The failure to consider the provision is a material defect.

II.

The Court seems to view as correlative the disallowance of the $25,000 deduction in Schalk's case and the determination of dividend equivalence in the individuals' cases. The same Tax Court "findings" are relied on (Op. pp. 6-8), although the statutory criterion for each issue is different, "ordinary and necessary . . . in carrying on any trade or business" as compared with "essentially equivalent to the distribution of a taxable dividend."

The Tax Court recognized the distinction. Its "finding" which the Court quotes (Op. p. 7), to the effect that the Tax Court was not "convinced" that a change in management "was either necessary or desirable to preserve its [Schalk's] business," went to deductibility of the $25,000, not its dividend equivalence. The finding played no part in the Tax Court's determination of the latter issue.[2]

The Court's treatment of the two issues as interrelated is a material defect.

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[2]The pivotal issue as to dividend equivalence of the $25,000 is: Did the individual petitioners derive any taxable economic benefit as a result of the $25,000 payment to Smith? *Niederkrome v. Commissioner of Internal Revenue,* 266 F. 2d 238 (9 Cir. 1958); *John A. Decker,* 32 T. C. 326 (1959), affirmed per curiam, 286 F. 2d 427 (6 Cir. 1960).

III.

The opinion's premise is that Schalk derived no benefit from the payments in question, but instead that the individual petitioners personally profited and benefited, and therefore the deduction claimed by Schalk was properly denied and the reimbursement was a dividend (Op. pp. 7-8).

The only "benefit" which it is suggested the individual petitioners gained was the right to participate in management and control of the company (Op. p. 7), a right which the Tax Court found they believed would prove beneficial to the company [R. 59]. The Tax Court was not of the view that the individual petitioners acted solely, or even "primarily", to secure a personal profit or benefit independent of the benefits which they believed would flow to the company. Nor did the Tax Court make any finding that the anticipated benefits to the company did not in fact materialize.

If the mere fact that the individual petitioners secured control makes the reimbursement a dividend, then this Court was wrong in remanding *Niederkrome v. Commissioner of Internal Revenue,* 266 F. 2d 238 (9 Cir. 1959), to the Tax Court to determine whether the shareholders who gained control in that case really derived any financial or economic benefit.

The opinion's preoccupation with an assumed lack of resultant benefit to Schalk is a material defect as to not only the dividend issue, but as well the deduction issue. According to the Court, the $25,000 payment could not have qualified in any event as an ordinary and necessary business expense because "the payment was not beneficial to Schalk" (Op. p. 7).

IV.

The opinion overlooks certain critical facts having an important bearing on proper evaluation of the Tax Court's findings.

First: The fact that in less than 3 years the other shareholders would have automatically succeeded to control of Schalk upon termination of the trust, without acquiring Smith's 1/6th stock interest, is not discussed. This is material because it negates the Court's supposition that the other shareholders were motivated solely by a personal desire to acquire control of the company.

Second. The fact that the other shareholders wanted *the company* to pay the $25,000 to Smith in the first instance, but that Smith refused to involve himself personally with the company because the company was controlled by him, is not discussed. This is material because it demonstrates that the other shareholders did not want to deal with Smith, but had to if they were to protect the company. The company could not act itself. It could act only through Smith.

Third. The fact that the settlement eliminated a substantial controversy over management of the company (the Farmans were directors), which was shown to be seriously disrupting the company's business and operations, is not discussed. This is material because payments to stockholders to alleviate management dissension have been held to be deductible as business expenses and have been held not to constitute constructive dividends. See, *e.g., Boulevard Frocks, Inc.,* T. C. Memo. Dec. (1943); *Fred F. Fischer,* T. C. Memo. Dec. (1947).

Conclusion.

For the foregoing reasons, a rehearing should be granted in this case.

June 19, 1962.

Respectfully submitted,

Donald Keith Hall,

Attorney for Petitioners.

Certificate of Counsel.

As counsel of record for petitioners, I certify that in my judgment the foregoing Petition is well founded and that it is not interposed for delay.

DONALD KEITH HALL.